DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 06-0470
Sales and Use Tax
For Tax Years 2002-05

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ISSUES

I. Sales and Use Tax—Exemptions**.**

Authority: *Indiana Dep't of Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983); IC § 6-2.5-4-6; IC § 6-2.5-5-3; IC § 6-8.1-5-1; 45 IAC 2.2-5-8; 45 IAC 2.2-5-10; 45 IAC 2.2-5-14; 45 IAC 2.2-5-16; Internet Tax Freedom Act § 1100-06, 47 U.S.C. § 151 note (2007)

Taxpayer protests the assessment of sales and use tax.

II. Tax Administration—Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2

Taxpayer protests the imposition of a ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana manufacturer. As the result of a refund investigation for tax years 2002 through 2005, and an audit covering tax years 2004 and 2005, the Indiana Department of Revenue ("Department") approved only a portion of Taxpayer's refund claim, and also issued proposed assessments for use tax for the tax years 2004 and 2005. Taxpayer protests these reductions of the refund it claimed, and also protests the assessments on the grounds that it qualified for several exemptions. Further facts will be supplied as required.

I. Use Tax—Exemptions**.**

DISCUSSION

Taxpayer protests that it qualified for several exemptions on items it purchased, and therefore does not owe sales or use tax on those items. Taxpayer believes that the proposed assessments

should be reduced and that the refund amount should be increased. The Department notes that Taxpayer bears the burden of proving a proposed assessment wrong, as provided by IC § 6-8.1-5-1(c).

Taxpayer's first point of protest concerns chemicals used in water treatment for production boilers and cooling towers. Taxpayer argues that the chemicals at issue are used in an exempt manner, and refers to 45 IAC 2.2-5-10(c), which states:

> Purchases of manufacturing machinery, tools, and equipment to be directly used by the purchaser in processing or refining are exempt from tax; provided that such machinery, tools, and equipment are directly used in the production process; i.e., they have an immediate effect on the tangible personal property being processed or refined. The property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which processes or refines tangible personal property.
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> –EXAMPLES–
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> (1) Whiskey is produced in a process that begins with the grinding and fermenting of grain and the distillation of the fermented mash, continues further with the maturation of the distilled alcohol and with the blending of individual whiskeys, and ends with the bottling, labeling, and packaging of the whiskey prior to shipment to customers. Because of the functional interrelationship of the various steps and the flow of the work-in-process, the total production process comprised of such activities is integrated.
>
> (2) The following types of equipment constitute essential and integral parts of the integrated production process and are, therefore, exempt. The fact that such equipment is built in a manner to service various pieces of exempt equipment, as an alternative to building the equipment into each of the pieces of exempt machinery, is not determinative.
>
> (A) *Pumps used to circulate cooling water through exempt condensers in the distillery.*
>
> (B) *Chemicals used to treat the water used in the production of whiskey to ensure that the water is pure or to prevent scale buildup in the boilers and pipes.*
>
> (C) Equipment used to pulverize coal prior to being fed into the exempt boiler used to generate steam in the distillation process.
>
> (D) A bottling and packaging process, which includes equipment such as case and bottle conveyors used during the filling operations, equipment to fill the bottles with product and to place labels on the bottles, and case filling equipment and case palletizers. The exempt production process begins after the bottles are introduced onto the bottle conveyors for the filling step of production and ends with the final packaging of the product onto the case palletizers.
>
> (3) Because of the lack of an essential and integral relationship with the integrated production process in Example (1), the following types of equipment are not exempt:

> (A) Equipment and furnishings located in the administrative offices of the plant.
> (B) Equipment used for research and development of new products.
> (C) Equipment used periodically to test the purity of the water in on-site deep wells which supply the plant's water requirements.
> (D) Racks on which cases of empty bottles are stored prior to their introduction into the bottling and packaging system.
> (E) The depalletizer used to strip pallets from cases containing empty bottles and unscramblers used to move empty bottles out of cases and onto the production line.

(*Emphasis added*.)

The Department determined that the water in Taxpayer's cooling system did not become a part of the finished product, unlike the water which becomes a part of the whiskey described in 45 IAC 2.2-5-10(c). Since the water did not become part of Taxpayer's finished product, the Department did not consider the chemicals used to treat the water to be exempt under 45 IAC 2.2-5-10(c).

Upon review, 45 IAC 2.2-5-10(c) describes two uses of water and chemicals to treat that water. One use is the water which becomes part of the whiskey. The other use is the water used as cooling water in exempt condensers in the production process. In the instant case, Taxpayer directly uses a water-cooled cooling system in the direct production of tangible personal property. The chemicals in question prevent scale build-up in an exempt cooling system. As provided by 45 IAC 2.2-5-10(c)(2)(B), those chemicals are exempt.

Taxpayer's next point of protest involves shipping pallets and lids. Taxpayer offers several arguments which stand for the position that Taxpayer either purchased the pallets and lids as non-returnable containers, or that Taxpayer purchased the pallets for resale. The pallets in question are leased from a supplier, loaded with Taxpayer's product, and shipped to Taxpayer's customers. The pallets are then returned from Taxpayer's customer's location to the supplier, without further action by Taxpayer. A review of the rental agreement between Taxpayer and the supplier shows that the pallets remain the property of the supplier. The agreement specifically states that the equipment shall at all times remain the exclusive property of the supplier and that Taxpayer has no right to sell or deal with the equipment in any way that is inconsistent with supplier's ownership of it.

The Department refers to 45 IAC 2.2-5-16, which states:

> (a) The state gross retail tax shall not apply to sales of nonreturnable wrapping materials and empty containers to be used by the purchaser as enclosures or containers for selling contents to be added, and returnable containers containing contents sold in a sale constituting selling at retail and returnable containers sold empty for refilling.
> (b) In general the gross proceeds from the sale of tangible personal property in a transaction of a retail merchant constituting selling at retail are taxable. This

> regulation [45 IAC 2.2] provided an exemption for wrapping materials and containers.
> (c) General rule. The receipt from a sale by a retail merchant of the following types of tangible personal property are exempt from state gross retail tax:
> (1) Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property.
> (2) Deposits for returnable containers received as an incident to a transaction of a retail merchant constituting selling at retail.
> (3) Returnable containers sold empty for refilling.
> (d) Application of general rule.
> (1) Nonreturnable wrapping material and empty containers. To qualify for this exemption, nonreturnable wrapping materials and empty containers must be used by the purchaser in the following way:
> (A) The purchaser must add contents to the containers purchased; and
> (B) The purchaser must sell the contents added.
> (2) Returnable containers sold at retail with contents. To qualify for this exemption, the returnable containers must be:
> (A) Sold in a taxable transaction of a retail merchant constituting selling at retail; and
> (B) Billed as a separate charge by the retail merchant to his customer. If there is a separate charge for such containers, the sale of the container is exempt from tax under this regulation [45 IAC 2.2].
> (3) Returnable containers sold empty. To qualify for this exemption the returnable container must be resold with the purpose of refilling. The sale of returnable containers to the original or first user thereof is taxable.
> (e) Definitions.
> (1) Returnable containers. As used in this regulation [45 IAC 2.2], the term returnable container means containers customarily returned by the buyer of the contents for reuse as containers.
> (2) Nonreturnable containers. As used in this regulation [45 IAC 2.2], the term "nonreturnable containers" means all containers which are not returnable containers.

Taxpayer protests that the pallets are not returned by its customers to Taxpayer, which is the lessee of the pallets. The pallets are returned to the supplier, which is the lessor of the pallets. Since the pallets are returned to the lessor, they are returnable pallets, and do not qualify for the exemptions which Taxpayer claims. While Taxpayer does not directly return the pallets to the supplier, the pallets are in fact returned to the supplier. There is no requirement that the lessee must directly return the pallets. The rental of the pallets and lids is not exempt.

Taxpayer's next point of protest concerns production machinery and equipment. Taxpayer states that its label printers and ribbons are used to produce labels which are placed on the outside of corrugated containers, which then receive final packaging. The labels provide information on the contents of the containers, as required by Taxpayer's customers. The labels are not shipping labels. The first relevant regulation is 45 IAC 2.2-5-14, which states:

> (a) The state gross retail tax shall not apply to sales of any tangible personal property which is to be incorporated by the purchaser as a material or an integral part into tangible personal property produced for sale by such purchaser in the business of manufacturing, assembling, refining or processing.
> (b) The exemption provided by this regulation [45 IAC 2.2] applies only to tangible personal property to be incorporated as a material or an integral part into tangible personal property produced for sale by a purchaser engaged in the business of manufacturing, assembling, refining or processing. This regulation [45 IAC 2.2] does not apply to persons engaged in producing tangible personal property for their own use.
> (c) This regulation [45 IAC 2.2] does not exempt from tax tangible personal property to be used in production, such as supplies, parts, fuel, machinery, etc., refer to Regs. 6-2.5-5-5(010) and 6-2.5-5-5(020) (dealing with material consumed in direct production) for the application of those regulations to taxpayers engaged in the production of tangible personal property.
> (d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. "Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:
> (1) That the material must be physically incorporated into and become a component of the finished product;
> (2) The material must constitute a material or an integral part of the finished product; and
> (3) The tangible personal property must be produced for sale by the purchaser.
> (e) Application of general rule.
> (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.
> (2) Integral or material part. The material must constitute a material or integral part of the finished product.
> (3) The finished product must be produced for sale by the purchaser.

Also, 45 IAC 2.2-5-8(d) states:

> Pre-production and post-production activities. "Direct use in the production process" begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required.
>
> –EXAMPLE–
>
> (1) The production of pharmaceutical items is accomplished by a process which begins with weighing and measuring out appropriate ingredients, continues with combining and otherwise treating the ingredients, and ends with packaging the items. Equipment used to transport raw materials to the manufacturing plant is employed prior to the first operation or activity constituting part of the integrated production process and is taxable. Weighing and measuring equipment and all equipment used as an essential and integral part of the subsequent manufacturing

> steps, through packaging, qualify for exemption. Equipment which loads packaged products from the packaging step of production into storage, or from storage into delivery vehicles, is subject to tax.

As provided by 45 IAC 2.2-5-8(d), direct use in the production process begins at the point of the first operation or activity constituting part of the integrated production process and ends at the point that the production has altered the item to its completed form, including packaging, if required. As provided in 45 IAC 2.2-5-14(e), the material must be physically incorporated into and become a component part of the finished product, the material must constitute a material or integral part of the finished product, and the finished product must be produced for sale by the purchaser. In the instant case, the labels are required packaging, thereby qualifying as part of the production process under 45 IAC 2.2-5-8(d). The labels are physically incorporated into the packaging, which is required, thereby becoming a component part of the finished product produced for sale by Taxpayer, thereby qualifying as exempt as provided by 45 IAC 2.2-5-14. The printers and ribbons which produce the components of the finished product are part of the production process and are therefore exempt.

Taxpayer's next point of protest concerns tilt tables, lift stations, hydraulic box dumper and scales used to weigh semi-finished goods. Taxpayer protests that these items are used in the production process and are therefore exempt under IC § 6-2.5-5-3(b), which states:

> Except as provided in subsection (c), transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

The Indiana Supreme Court addressed the issue of direct production in *Indiana Dep't of Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983). In deciding that trucks transporting unfinished stone from one production step to the next, the court explained:

> In the present case, the transportation equipment was essential to the job of producing or processing aggregate stone. Inasmuch as the finished product could be produced only if stone were transported from the quarry to the crusher and from the crusher to the stockpiles, the transportation equipment was directly used by the taxpayer in the direct production of aggregate stone.
> *Id.* at 525.

In the same way that the trucks in *Cave Stone* made the production process possible, so do the tilt tables, lift stations, hydraulic box dumper and scales used to weigh semi-finished goods in the instant case. These items are therefore exempt as provided by IC § 6-2.5-5-3(b).

Taxpayer's final point of protest concerns the fees it paid to subscribe to a virtual private network (VPN) which connects Taxpayer to its customers for the purpose of sharing information. Taxpayer believes that this is a non-taxable internet service. The Department determined that Taxpayer was licensing the use of a software system while using some dedicated hardware to

exchange information between Taxpayer and its customers over the shared or public environment of the internet. The Department did not consider these purchases as internet access, but simply the purchase of software and use of hardware for which the vendor did not charge. Taxpayer has offered evidence that the vendor is in a business which depends on the internet, but there is insufficient evidence to establish that the vendor actually provides internet access.

Taxpayer states that there was no exchange of tangible personal property, and therefore the transaction is not subject to sales tax. The Department notes that internet access is in fact subject to sales and use tax, under IC § 6-2.5-4-6, which states:

> (a) As used in this section, "telecommunication services" means the transmission of messages or information by or using wire, cable, fiber optics, laser, microwave, radio, satellite, or similar facilities. The term does not include value added services in which computer processing applications are used to act on the form, content, code, or protocol of the information for purposes other than transmission.
>
> (b) A person is a retail merchant making a retail transaction when the person:
>
> (1) furnishes or sells an intrastate telecommunication service; and
>
> (2) receives gross retail income from billings or statements rendered to customers.
>
> (c) Notwithstanding subsection (b), a person is not a retail merchant making a retail transaction when:
>
> (1) the person provides, installs, constructs, services, or removes tangible personal property which is used in connection with the furnishing of the telecommunication services described in subsection (a);
>
> (2) the person furnishes or sells the telecommunication services described in subsection (a) to another person described in this section or in section 5 of this chapter;
>
> (3) the person furnishes telecommunications services described in subsection (a) to another person who is using a prepaid telephone calling card or prepaid telephone authorization number described in section 13 of this chapter; or
>
> (4) the person furnishes intrastate mobile telecommunications service (as defined in IC 6-8.1-15-7) to a customer with a place of primary use that is not located in Indiana (as determined under IC 6-8.1-15).
>
> (d) Subject to IC 6-2.5-12 and IC 6-8.1-15, and notwithstanding subsections (a), (b), and (c), if charges for telecommunication services not taxable under this article are aggregated with and not separately stated from charges subject to taxation under this article, the charges for nontaxable telecommunication services are subject to taxation unless the service provider can reasonably identify the charges not subject to the tax from the service provider's books and records kept in the regular course of business.

Taxpayer states that the service is interstate in nature, but has not supported this position with documentation. Taxpayer also states that federal law prohibits the taxation of internet service, under the Internet Tax Freedom Act. *See* Internet Tax Freedom Act § 1100-06, 47 U.S.C. § 151 note (2007). The Department notes that the Act specifically excludes telecommunications

services offered by telecommunications providers in its definition of internet access services. *Id.* § 1105(5). Therefore, even if the vendor is a telecommunications provider, the service in question here is not considered internet access under the Act, and Taxpayer's reliance on the Act is misplaced. The available information regarding the VPN does not rise to the level required by IC § 6-8.1-5-1(c) to prove the proposed assessment wrong.

In conclusion, the chemicals used to treat the cooling system water are exempt. The shipping pallets are returnable containers, and are subject to sales and use tax. The label printers and ribbons are exempt. The tilt tables, lift stations, hydraulic box dumper and scales used to weigh semi-finished goods are exempt. The VPN fees are subject to sales tax.

FINDING

Taxpayer's protest and claim for refund are sustained in part and denied in part.

II. **Tax Administration**—Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

> If a person:
> …
> (3) incurs, upon examination by the department, a deficiency that is due to negligence;
> …
> the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full

> amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). While Taxpayer was partially sustained in Issue I, Taxpayer was also partially denied in Issue I. Taxpayer has not affirmatively established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

WL/BK/DK September 17, 2007.